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Safe banks need not mean slow economic growth

By Thomas Hoenig

Before 2007, the owners of America's largest banks contributed as little as three cents of common equity for every dollar on their balance sheets. The capital requirements in place at the time were little constraint on the use of debt by these banks to fund purchases. Given the devastating effect of the financial crisis on US jobs and wealth that followed, would anyone really want to argue that requiring the biggest banks to hold more equity in 2007 would have adversely affected economic growth?

So, last month, US bank supervisors proposed a new capital standard that would limit the largest banks' ability to finance themselves with excessive amounts of debt. For every dollar of assets and some proportion of off-balance-sheet commitments, the largest banks would hold at least six cents of equity, and their parent holding companies would hold five cents. This cap on the banks' leverage ratio would significantly increase capital requirements for these banks, enhancing their ability to withstand financial shock and continue lending.

The largest banks are raising objections designed to scare the public and force a retreat from good public policy. The new requirements are not onerous, however. The proposed higher leverage ratio is intended only to reduce the banks' vulnerability by requiring more owner equity, just as the market would have required of the megabanks if there were no government backstop. Since the early 20th century, capital levels for the largest financial groups have systematically declined from levels exceeding 15 per cent of assets to below 3 per cent for several of the largest banks in 2007.

One of the more frequent objections asserts that the proposed increase in equity capital will force banks to curtail lending in the short term and thereby inhibit the recovery. This is false. An increase in debt over equity may temporarily boost asset growth, but it does so at the taxpayer's expense, by making large banks – and the real economy – more vulnerable to shocks. The public should not accept the liability associated with a highly leveraged banking industry as the price of credit and economic growth. A review of real-world data since 1999 on the relationship between equity and loan levels for the eight US globally systemic banks found no evidence that higher capital leads to lower loan volumes over the long run. Indeed, banks with thick capital cushions are better able to maintain lending during a crisis – a key factor influencing the speed of the recovery.

It is also often suggested that higher equity requirements would put US banks on an uneven playing field versus their global peers. I have seen no credible evidence to substantiate this concern. At the moment, European banks, which were even less well capitalised than US banks at the start of the financial crisis, now appear unable to lend or grow. It is simply a fact that the banks that have been most successful over the long run are those that held more and better capital than their competitors.

Some have argued that relying on a leverage ratio in which all assets receive the same risk weighting will cause bank management to invest in the riskiest assets to offset the effects of having to hold more equity. That assertion ignores the fact that the ratio is not the only measure by which we are proposing to assess capital adequacy: we would also be using the Basel risk-weighted capital requirements to complement the leverage ratio and thus mitigate the potential for arbitrage.

Finally, it has been suggested that higher capital requirements would result in lower returns on equity, which would hurt the industry's ability to attract capital. This is misleading. Equity, like debt, is a source of funds that is invested and earns a return. It is not a reserve to be locked away somewhere to be pulled out in an emergency. But, being owner equity, it cannot run in a crisis. It serves to absorb loss and reduce the bank's overall risk profile. Equity enhances the reliability of the bank's earnings stream and is attractive for many investors.

It is telling that, from 1980 to 2007, there is little evidence that high rates of return caused any banks to seek and attract new capital to fund their own growth. During that period, new common stock was raised only seven times by the largest US banks. Bank managers attempted to raise common equity capital so infrequently during prosperous times that their warnings about an inability to "attract capital" as a major constraint are dubious. Furthermore, since 2007, when returns were at historical lows, new equity was raised 18 times – excluding times the US government was forced to invest in the banks to prop them up. Even during a bank crisis, banks could attract capital.

The US has an opportunity to promote financial stability by making commercial banking safer. It will lead the world by doing this. It is time to compete in the global economy from a position of strength once again. The US is a market economy, and we know that capital is a source of strength, not a burden.

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